BRITISH COLUMBIA

FINANCIAL INSTITUTIONS AND FINANCIAL INTERMEDIARIES - REVIEW OF BRITISH COLUMBIA'S REGULATORY LEGISLATION

PROPOSED SIGNIFICANT POLICY CHANGES

November 2003

Ministry of Finance
Province of British Columbia

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Purpose

The purpose of this paper is to outline the significant policy changes proposed for the *Financial Institutions Act* (FIA) and the *Credit Union Incorporation Act* (CUIA) arising out of the review of the financial services sector regulatory framework. The release of this paper is part of the second phase of the review process. The first phase of the review process involved the development of a public discussion paper and consultation with stakeholders on changes to the regulatory framework. The phase one discussion paper and report on the results of the consultation process can be viewed at: http://www.fin.gov.bc.ca/PT/fcsp/firstconsult.shtml

The paper outlines and provides a brief discussion of the proposed significant policy changes. Additional policy and technical administrative changes are under consideration but are not discussed in this paper. Specific amendments to the FIA and CUIA (as well as related amendments to regulations under those statutes) will be prepared for planned introduction in the Spring 2004 legislative session. Further directed consultation will be undertaken as part of the legislation development process.

The paper is organized similarly to the phase one discussion paper and report on consultations, which provide background on the issues, options and comments received during consultations. The paper begins by restating the objective and principles that were established for the review. The government has now approved these objectives and principles. The proposed changes to the FIA and CUIA are organized into three sections – regulatory framework, reducing the risk of insolvency and protecting consumers.

Each proposed change is described and discussed in the context of the objectives and principles. Where no major changes are proposed, this is noted. Comments on the proposed significant policy changes to the financial sector legislative framework are invited. Any comments should be submitted by December 12, 2003 to the Financial and Corporate Sector Policy Branch:

- By email, FCSP@gems7.gov.bc.ca

- By mail, Financial and Corporate Sector Policy Branch
  Ministry of Finance
  PO Box 9418 STN PROV GOVT
  Victoria BC, V8W 9V1

- By delivery, Financial and Corporate Sector Policy Branch
  Room 201 - 553 Superior Street
  Victoria BC, V8W 9V1

Unless confidentiality is specifically requested, comments received electronically will be posted on the Ministry of Finance website http://www.fin.gov.bc.ca/PT/fcsp/consult.shtml to add to the transparency and interactivity of the process. Other written comments may be placed or referenced on the website. Although responses requesting confidentiality will not be placed on the website, freedom of information legislation may require the Ministry to make responses available to those requesting such access.

Objective and Principles

The primary objective of regulating financial institutions and their intermediaries is to enhance and maintain confidence in the financial services sector.

The principles that have been used as the basis for evaluating options and identifying the proposed major policy changes are:

- Directly contribute to the objective
- Be the least cost solution (with cost including administrative, compliance and economic costs)
- Contribute to a competitive market
- Represent a proportionate response to the issue
- Be flexible
- Make regulators and those being regulated accountable.

In developing reform options for the government's consideration, each option was considered and balanced against the primary objective and the principles.

Regulatory Framework

Provincial Financial Institutions

No major changes are proposed to the regulatory approach for provincial financial institutions. Although, historically, there has been some concern expressed with the single statute approach to the regulation of all provincial financial institutions, the approach is now generally accepted by all sectors.

Extra-Provincial Financial Institutions

There are two aspects of the regulation of extra-provincial financial institutions – solvency regulation and market conduct regulation (consumer protection provisions including disclosure, confidentiality, fair practices and prohibited methods of doing business).

The primary issue respecting the regulation of extra-provincial financial institutions is how to best balance the objective of enhancing and maintaining confidence with the principle of least cost. For institutions subject to different rules and requirements in several jurisdictions, the cost of complying with different requirements has been a longstanding issue. Often, competitors are regulated by only one jurisdiction. Regulatory requirements are only part of the issue. Regulatory enforcement is another, as there are costs associated with assuring each regulator that there is compliance.

To most effectively meet the primary objective of the financial services sector regulation, while reducing costs of compliance and regulatory enforcement, the FIA will be amended to:

- ***Provide that only federally incorporated trust companies can be authorized to do business in the province***

  Similar to the approach recently adopted in Ontario, British Columbia will no longer grant business authorizations to trust and loan corporations incorporated in other provinces. Only federally incorporated trust and loan corporations will be able to operate in the province. Federal trust and loan corporations will be automatically granted a business authorization on application and will no longer be subject to provincial solvency regulation. The Superintendent of Financial Institutions will be responsible only for enforcing the prohibition against engaging in unauthorized trust and loan business.

  At present there are five provincially incorporated trust and loan corporations operating in British Columbia (one from Manitoba and four from Québec). These five corporations will be "grand-parented" and an approach to solvency regulation that is substantially similar to the approach proposed for insurance corporations (discussed below) will be applied.

  This proposal meets the primary objective while reducing the overall regulatory burden. It recognizes the contraction in the trust industry sector and allows resources to be directed to other regulated areas. It continues to provide the option for trust and loan corporations to operate within the province but in a streamlined way by providing that all such corporations must be federally regulated.

- ***Enhance the current approach to the regulation of extra-provincial insurance corporations by placing greater reliance on the primary regulatory for solvency regulation***

  Under this proposal an insurer incorporated in a designated jurisdiction (federal or provincial) will be, upon application, automatically granted a business authorization to do business in British Columbia if it has already been granted an authorization to do business in the jurisdiction in which it is incorporated. In order to be designated, a jurisdiction will have to have prudential and solvency requirements equivalent to the British Columbia legislation, along with effective enforcement of the requirements. These insurers will be subject to the solvency requirements of the designated jurisdiction only. The Superintendent will rely mainly on the regulator in the designated jurisdiction (primary regulator) for solvency regulation of the extra-provincial insurance corporation.

  The Superintendent will, however, continue to monitor the solvency of the corporation by reviewing the reports required by and examinations undertaken by the primary regulator. The Superintendent will be entitled to request from the insurer only information that he is unable to obtain from the primary regulator. The Superintendent will also retain enforcement powers to take action if warranted.

  This proposal meets the primary objective and is consistent with the least cost principle, as it will reduce regulatory overlap and duplication on financial institutions operating in more than one jurisdiction. It is a proportionate response as the Superintendent retains some level of regulation but envisions that these powers will be used only in extraordinary circumstances.

- ***Make British Columbia's market conduct rules more consistent***

  It is proposed that British Columbia's market conduct rules continue to apply to all transactions in British Columbia, regardless of whether it is undertaken by a provincial or extra-provincial financial institution. However, British Columbia rules will be changed to be generally consistent with accepted and adopted standards in place throughout Canada.

  By minimizing the number of unusual and unique regulatory requirements imposed by British Columbia, the overall regulatory burden on and compliance costs for extra-provincial financial institutions will be significantly reduced. This proposal is also consistent with the competitiveness of the market principle by providing that all firms are subject to similar, and relatively consistent, rules when operating in British Columbia.

  The proposed changes to the market conduct regime are discussed in detail below in another section of this paper.

Regulatory Roles and Responsibilities

There was not a comprehensive discussion of regulatory roles and responsibilities under the FIA in the discussion paper. However, in analyzing the issues raised and the feedback received in response to the discussion paper, a number of additional issues respecting the division of regulatory responsibilities and the appropriate role of the Minister, the Financial Institutions Commission and the Superintendent have been raised for consideration.

One issue is whether it is necessary to have the Minister take such a large role in the regulation of financial institutions given the existence of the Commission. When the Act was first passed, it was envisioned that the Minister would bring a broad public interest perspective to the regulation of financial institutions. Over the years, the courts have made it difficult for the public interest to be successfully used to deny an application in the absence of other valid regulatory or administrative reasons to deny the application. Given this, and the extensive due diligence at the regulator's level, the involvement of the Minister may be unnecessary and impose unnecessary compliance costs in terms of time and process.

Another related issue is what is the appropriate role of the Commission vis-à-vis the Superintendent. Questions have been raised about lines of accountability and whether it is currently implicit in the structure that the Superintendent is accountable to the Commission. There is no explicit accountability relationship between the Superintendent and the Commission, although the Chair of the Commission is responsible for appointing the Superintendent.

To address these issues, the FIA and CUIA will be amended to alter the roles and responsibilities of the Minister, the Commission and the Superintendent. The Minister will be removed from statutory decision-making responsibilities under the Acts and the Commission will become responsible for those regulatory decisions formerly taken by the

Minister[1]. The Commission will thus become the primary regulatory authority for financial institutions operating in the province, including making fundamental decisions, taking major enforcement actions and having overall responsibility for regulation.

The Superintendent will continue to be responsible for the day-to-day administration of the Act and the ongoing regulation of financial institutions operating in the province based on delegated authority from the Commission, to whom the Superintendent will be accountable. These changes are consistent with meeting the primary objective, but are designed to streamline and rationalize certain approval and consent processes to reduce costs and increase efficiencies.

Compliance

Appropriate regulatory powers are a core element of the infrastructure necessary to achieve regulatory objectives and that is true with financial institutions' regulation. If there is a gap in powers that at times prevents regulators from having a proportionate response, there will be additional costs if the regulator either over reacts or under reacts. The most prominent gap is the inability of the Superintendent to levy administrative penalties.

The FIA will be amended to give the superintendent the authority to levy administrative penalties for prescribed contraventions of the Act, regulations and orders, agreements or undertakings. Regulations will also set out the penalty or maximum penalty for each prescribed contravention, up to an overall statutory maximum of $25,000 for individuals and $50,000 for institutions or corporations. Checks and balances to be built into the provisions include the right of appeal, notice and hearing requirements, a two-year limitation period, criteria for assessing penalties and no "double indemnity".

The FIA will also be amended to make certain other enhancements to the current enforcement framework:

- allow payment into court of assets that have been frozen by the Superintendent and allow those with legitimate claims to apply to court for the money;
- authorize the Insurance Council to recover hearing costs from persons subject to the hearing, and authorize the Superintendent and the Commission to recover both investigation and hearing costs from persons subject to the hearing. The maximum amounts of investigation and hearing fees will be prescribed, as they currently are under the *Securities Act*;
- expand the Insurance Council's administrative penalty power to authorize the Council to impose penalties for contraventions of the FIA, in addition to their current power for breaches of license conditions;
- authorize the Insurance Council to compel witnesses and production of documents at the investigation stage.

[1] For example, consenting to incorporations, although without a public interest test; approving fundamental changes; granting business authorizations; ordering windings up and taking major enforcement decisions, such as removal of business authorizations.

These changes are intended to ensure that regulators have the appropriate tools to respond to non-compliance, balanced with the principles of ensuring a proportional response and accountability of regulators and market participants.

Stabilization

No major policy changes are proposed to the stabilization framework for credit unions.

A specific issue raised in the discussion paper concerned the appropriate level of capital at which a credit union could be forced to amalgamate or dispose of assets and liabilities. The level of capital at which the regulator may take this action will be raised from two percent to five percent. As is currently the case, the regulator will not be required to take action if capital falls below the threshold, but will have the flexibility to do so if it felt that this regulatory action is necessary. Concerns regarding the appropriate use of this power will be tempered with clear guidelines based on experience as to when forced amalgamations and mergers are required.

Reducing the Risk of Insolvency

Corporate Governance

No major policy changes are proposed at this time to the corporate governance framework for financial institutions. The existing *Financial Institutions Act* imposes a high standard of care that places accountability and responsibility for reasonably prudent behaviour on the directors and officers of the financial institution and sets out a comprehensive corporate governance framework. This approach is considered best practice by many jurisdictions for all types of corporations.

Extra-Provincial Operation of Credit Unions

Three major changes to the credit union regulatory framework will be made under the CUIA:

Extra-provincial operation of credit unions

A credit union incorporated in British Columbia will be allowed to operate extra-provincially, subject to the laws of the other jurisdiction. Credit unions wishing to operate extra-provincially will require the approval of the Financial Institution Commission (FICOM) and the Credit Union Deposit Insurance Corporation (CUDIC) to seek extra-provincial registration. Credit unions incorporated in other provinces will also be allowed to apply to FICOM for an authorization to do business in BC, but only if the incorporating jurisdiction allows for reciprocal registration of BC credit unions. Extra-provincial credit unions would be subject to a solvency regulatory regime, similar to that proposed for extra-provincial insurers.

In both cases, depositors will be covered by the deposit insurance of the credit union's home jurisdiction (residents of other provinces will be subject to CUDIC coverage if the credit union is incorporated in BC and BC residents doing business with a credit union from

another province will be covered by the deposit insurance in that province). Appropriate disclosure will be required.

This change is consistent with the principle of flexibility and maintains the appropriate lines of accountability. By paralleling existing provisions in Ontario and Saskatchewan credit union legislation, BC credit unions are put on an equal footing. However, it is recognized that this proposal will impose certain administrative costs and additional regulatory requirements (associated with being subject to regulatory oversight in two or more jurisdictions) on credit unions choosing to take advantage of this opportunity.

Continuation into the province

A credit union from another jurisdiction will be permitted to continue into British Columbia and operate as a British Columbia credit union, subject to the approval of FICOM and CUDIC. After continuation, CUDIC will provide deposit insurance, possibly subject to some grand-fathering of term deposits, arranged by agreement as part of the continuation. This change is consistent with the principle of flexibility.

Continuation out and conversion

A British Columbia credit union will be permitted to continue out of the province and apply to become a credit union in another jurisdiction or to convert to another form of financial institution, subject to the approval of the members, FICOM and CUDIC, and to the laws of that jurisdiction. On continuation or conversion, substantially all regulatory and deposit insurance obligations will cease and the continued credit union or converted entity will become the sole responsibility of the new jurisdiction. Consideration may, however, have to be given to continuing CUDIC deposit insurance for the unexpired term of deposits in the credit union (depending on the protection available after continuation or conversion).

This proposal supports the principles of flexibility and competitive market.

Authorization to Engage in Business

No changes are proposed in respect of the prohibitions against engaging in deposit or insurance business, unless authorized under the Act or exempted from the requirement.

The discussion paper asked whether it is necessary to continue to regulate *trust business* in order to maintain and enhance confidence in the financial services sector. Under the proposed amendments, the FIA will no longer provide for the incorporation and regulation of provincial trust companies to undertake deposit business. British Columbia will, however, continue to incorporate trust-only trust companies, which will continue to be regulated under the FIA. However, the regulation of trust business will be focused on those entities that are otherwise unregulated and thus not subject to any oversight, or where regulation is disproportionate and costly given the nature of the trust business engaged in and the potential harm to the consumer. Exemptions to the trust business restriction will be established by regulation. Types of regulated institutions engaged in trust business as part of their broader financial business will be exempt (these include mutual fund companies, credit unions and other firms offering RRSPs,

RRIFs and RESPs under the *Income Tax Act)*. It will also be possible to exempt companies on a case-by-case basis.

Operations

The FIA will be amended to:

- ***Expand the list of permitted businesses that a financial institution may engage in directly***

  The list will generally be expanded to include businesses that financial institutions operating in other Canadian jurisdictions are permitted to undertake. It will include certain businesses that are appropriate within the context of the overall nature of the financial services sector, but which may not generally be considered a financial service. A British Columbia financial institution will also be permitted to have a substantial investment in, or own, a subsidiary engaged in any of the permitted businesses that a financial institution may engage in directly. Specific provisions will allow British Columbia financial institutions to network and otherwise enter into arrangements for shared services and administration.

  Extending the business powers of British Columbia financial institutions will ensure that British Columbia firms are competitive generally and with extra-provincial financial institutions. Corporate governance provisions and the regulation of investment and lending will ensure that the business decisions of the financial institution are in the best interests of its depositors and policy-holders. These changes will provide British Columbia firms with flexibility to structure their operations in accordance with their business needs and goals.

- ***Permit financial institutions to sell insurance directly***

  The FIA will be amended to allow credit unions and trust companies to sell insurance directly, rather than through an insurance agency subsidiary. Employees of financial institutions that sell insurance will be required to be licensed as insurance salespersons. Maintaining the current insurance licensing regime, while allowing financial institutions to sell insurance directly, continues to meet the primary objective of financial services regulation while supporting the principles of flexibility and accountability. There may be some concerns that this change will increase the risk of consumers being subjected to tied-selling. However, the FIA's market conduct provisions (discussed below) will address conflict of interest situations and prohibit coercive tied selling.

- ***Permit financial institutions to share premises with insurance agencies***

  Credit unions and trust companies will be permitted to share premises with insurance agencies or their insurance agency subsidiaries if they decide not to sell insurance directly.

  This proposal is consistent with meeting the primary objective; the current insurance licensing framework remains intact. This option will simply eliminate an unnecessary restriction on the business operations of financial institutions that is inconsistent with the

competitive market principle and not required from a consumer protection viewpoint. Market conduct rules will address any potential consumer protection issues.

- ***Eliminate restrictions on the location of offices and records***

  The current requirements to provide notice of all changes in location of office and to maintain records of loans, deposits and insurance contracts in British Columbia will be eliminated. Similar to the requirement for extra-provincial corporations, records will simply be required to be accessible from British Columbia.

  This proposal eliminates provisions that are no longer appropriate given technological developments. It maintains the principle of accountability by requiring records to be accessible from British Columbia, but reduces the costs associated with the requirement to maintain a physical record in British Columbia.

Capital and Liquidity - Deposit Taking

The discussion paper considered whether the current approach to capital and liquidity could be improved in terms of its consistency with the principles. The issues are: whether the current risk-weighting approach can be improved and costs reduced by making changes or harmonizing more exactly with other regulatory jurisdictions; and whether the liquidity requirements placed on credit unions are unnecessarily onerous or inflexible.

It is proposed that:

- Changes to the current capital adequacy regulation be made to address specific issues and to enhance consistency with the approach for chartered banks.

- Flexibility be added to the FIA to allow new approaches to be adopted if and when needed (e.g., as a result of developments in other jurisdictions).

- The liquidity requirements and ratio for credit unions be adjusted to parallel the Alberta and Ontario requirements, but credit unions will have the option of complying with these prescriptive requirements or preparing and filing their own liquidity policy with the Superintendent for approval. Discussions will be held with Credit Union Central of BC and the credit union system, to implement this option in a manner that does not impair the operation of the liquidity pool.

This proposal directly contributes to the primary objective by enhancing a key feature of solvency regulation. By ensuring consistency with other jurisdictions, the change is consistent with the least cost and competitive market principles.

Capital and Liquidity - Insurance

Issues have arisen about whether the current approach to capital adequacy for insurers could be improved in light of recent federal changes that explicitly base capital adequacy regulation for insurers on risk.

The FIA will be amended to generally apply the federal approach to ongoing capital adequacy for insurers to provincial insurance companies. The federal Minimum Capital Test will be applied to provincial property and casualty insurance companies and the Minimum Continuing Capital Surplus Requirement test will be applied to provincial life companies. The existing minimum capital requirements of $3 million for general insurers, $5 million for life insurers and $10 million for an insurer authorized to undertake both general and life insurance business will be maintained. Additionally, provincial insurers will be explicitly required to maintain sufficient liquidity.

The proposed changes will ensure that the regulation of capital and liquidity is up to date and consistent with current best practice, as well as enhancing consistency and promoting competitive equity.

Investment and Lending

No major policy changes are proposed to the investment and lending regime for financial institutions.

Related Party Transactions

It is important that financial institutions avoid putting the interests of owners, directors and managers ahead of the interests of the financial institution and its depositors and policy holders. Given the historic problems associated with self-dealing in Canadian financial institutions failures, regulating related party transactions is an important element of solvency regulation. However, the current regime is complex, inflexible and difficult to comply with. Other jurisdictions have effective related party regulation that has lower compliance costs.

The FIA will be amended to replace the current detailed approach to defining related parties and restricting transactions with related parties with an approach that relies on:

- the updated conflicts of interest provisions in the recently introduced *Business Corporations Act* which will apply to all other provincial corporations, and

- a requirement that a financial institution's prudent investment and lending standards and operational decisions must ensure that all transactions and decisions are in the best interest of the financial institution.

This change is consistent with the primary objective in that it continues to provide a level of control and oversight by the financial institution over conflicts of interest. It will result in a reduction in regulatory burden to financial institutions as it utilizes and expands existing prudential requirements. It is also consistent with other prudential requirements that make financial institutions responsible and accountable for their operational decisions.

Protecting Consumers

Consumer Compensation

No major policy changes are proposed to the current consumer compensation framework.

Market Conduct

The following major policy changes will be made to British Columbia's market conduct provisions:

- ***Prohibit only coercive tied selling***

  The FIA will be amended to clarify that only coercive tied-selling practices are prohibited. This change will permit the bundling of financial products and other financial arrangements, (including preferential pricing) that are not harmful, but in fact are beneficial to consumers. As part of this change, it may be necessary for the Superintendent to provide administrative policy direction to the financial services sector as to what constitutes coercive tied selling and non-coercive tied selling.

- ***Permit rebating***

  The FIA will be amended to repeal the prohibition on rebating, an obsolete solvency regulatory tool that is no longer necessary. The insurance licensing regime will continue to ensure that consumers receive competent, expert advice from qualified professionals. Eliminating the rebating prohibition will provide the industry with flexibility and the ability to offer advantageous contractual terms. It will also benefit consumers by reducing the cost of services.

- ***Update disclosure and confidentiality provisions***

  The FIA will be amended to:

  - Allow customer information collected or obtained by one financial institution or financial intermediary to be shared with another financial institution or financial intermediary with the express consent of the customer. This proposal is consistent with the primary objective. It reduces compliance costs and regulatory burden and establishes an appropriate and reasonable framework for ensuring consumer confidentiality while allowing for disclosure of customer information with the permission of the customer.

  - Streamline and rationalize the variety of information that must be disclosed to consumers to focus on providing only specific information that is of direct use and benefit to consumers. This change is consistent with the primary objective. The intent of the change is to continue to require the disclosure of information needed by consumers – information on agency or networking relationships where it is not clear for whom the person is working or acting as an agent; and information on whether the person selling the financial product or service will receive a commission and from whom. However, it

will reduce regulatory and compliance costs to industry by streamlining the current disclosure requirements.

- ***Eliminate restrictions on terms***

  The FIA will be amended to eliminate the current provision establishing restrictions on the use of the word "guarantee" with respect to financial instruments

Regulation of Insurance Brokers, Agents and Adjusters

Insurance Licensing Regime

The FIA will be amended to expand the list of exemptions, allowing additional types of insurance to be sold by unlicensed individuals and entities. Exemptions will be provided where: the insurance product is straightforward and relates to another product; there is a highly controlled and supervised sales environment; and/or the imposition of the licensing requirement would be disproportionate and costly. In particular, consideration will be given to exempting:

- motor dealers generally in respect of motor vehicle warranty insurance,
- travel agents selling travel insurance,
- subsidiaries of product retailers,
- funeral service providers, and
- third party contractors of financial institutions selling insurance products that financial institutions' employees are currently allowed to sell, provided that the contractual arrangement between the financial institution and the contractor makes the financial institution liable for the actions of the contractor.

This proposal is consistent with the primary objective. It continues to provide for a comprehensive licensing regime for individuals selling general and life insurance to ensure that consumers are protected by dealing with knowledgeable individuals and reducing the risk of premiums being misappropriated. However, it meets the least cost principle, the proportionate response and accountability principles by providing reasonable exemptions for specific products where the risk of harm to the consumer is low, but where the potential costs of compliance with a licensing regime are high.

Insurance Council

The FIA will also be amended to provide the Insurance Council with limited rule-making authority. Specifically, the Insurance Council will be granted authority to make rules, or pass bylaws, respecting the code of ethics, standards, qualifications and requirements for the licensing of insurance salespersons, agents and adjusters. At present such requirements are set by regulation. To ensure appropriate checks and balances on the Council's authority, some Ministerial oversight of Council rules or by-laws will be established, similar to the current ministerial oversight of rules made by the British Columbia Securities Commission.

This change is designed to provide flexibility and allow timely response to changes in industry practice. It should also reduce the overall costs of regulation by moving from the requirement for prescriptive regulations passed by the Lieutenant Governor in Council to the establishment of bylaws or rules made by the regulator of the insurance retailers. Ministerial oversight will ensure rule-making is consistent with the accountability and proportionate response principles.